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CONSEQUENCES OF RISING INCOME INEQUALITY. A COMMENT

by

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Abstract

Rising income inequality is an anglo Saxon problem. For most of the other OECD countries, earnings dispersion is rather persistent. Vertical mobility is to be taken into account. The paper also looks at the relationship of income inequality, growth and employment. It elaborates the point that equity orientation affects the incentive system of an economy and can lead to higher unemployment.

J.E.L.-Klassifikation: D3, D6, I3, J00

*I. The empirical picture**

1. The topic of rising income inequality is an anglo-saxon problem. According to World Bank data for a large sample of countries, Gini coefficients on market income have increased in the last four decades for the Unites States, the United Kingdom and New Zealand (Table 1 in the appendix). The trend is insignificant for most of the other industrialized countries, among them (West)Germany,[1,2] and for some developing countries including the Asian NICs. For France[3] and Italy, two of the larger continental European countries, it is even negative. This picture is more or less confirmed by the Luxembourg Income Study (LIS) for most of the OECD countries (Table 2). In the eighties and early nineties, the Gini coefficients for disposable income increased for the anglo-saxon countries, now also including Australia; they also rose for the Netherlands, Sweden and Japan. For the other OECD countries there was no significant trend. In most countries, income distribution seems to be quite persistent.

As an example for the trends in income distribution, take the earnings dispersion (for men) measured by the D9/D1 ratio which shows a steady increase

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* This is a comment to a paper with the same title by Joseph Stiglitz, Symposium „Income Inequality: Issues and Policy Options", Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wy, August 27-29, 1988. This paper is a rational expectation comment and had to be written before the paper to be commented on was available. I appreciate critical remarks from Alfred Boss and Rainer Thiele.

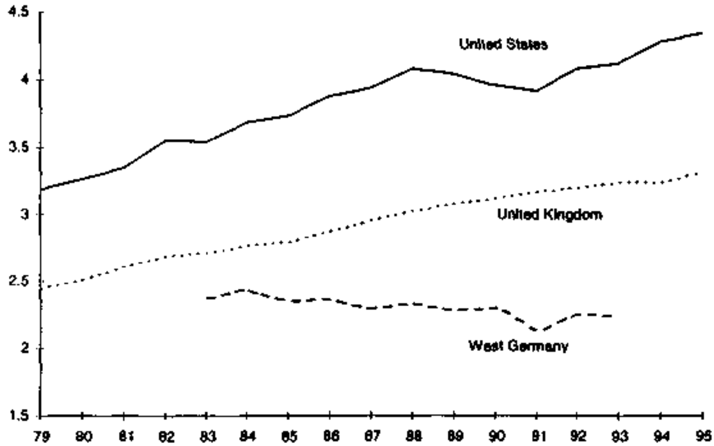
1 Biewen (1998) finds a slight reduction of income inequality in West Germany for the period 1985–1996. Note that changes in the Gini coefficients are affected by the choice of the equivalence scale for household size. For instance, there is a slight increase in the Gini coefficient in 1995 according to the Bundesamt-scale and a decrease according to the OECD scale (Biewen 1998, tables 1 and 5). Burkhauser et al. (1988) show a slight increase in the Gini coefficient in the period 1994–1995 for labor earnings and in the period 1992–1996 for post government income (Table 3).

2 In East Germany inequality has risen during 1990–1996. In reunified Germany inequality has drastically reduced due to the growth of mean income in East Germany.

3 Income distribution remained nearly constant in France according to Atkinson, Rainwater and Smeeding (1995).

in the eighties and the nineties for the US and the UK whereas the ratio remains constant for West Germany; in terms of the level of dispersion, the ratio of the US is the double of that of West Germany (Figure 1).

Figure 1 — Earnings dispersion in selected countries[a]



[a]Men, Ratio of upper earnings limits of the ninth decile (D9) to the first decile (D1) of employees when employees are ranked in order of their earnings from lowest to highest.

Source: Siebert (1998) according to data from OECD (1996), Table 3.1.

2. Before deriving policy conclusions in terms of a more equity oriented redistributional policy, we should be aware that the income distribution observed within a given year is only a snapshot. The snapshot dispersion does not fully capture the longer-term picture, since there is vertical mobility of individuals over time across the income distribution. Within a five-year period, there is a considerable vertical mobility in the OECD countries. Over that period, in the United Kingdom and the United States slightly more than half of the employees move up one or more quintiles (Table 3). In Germany (46.9) and France (43.2) a smaller percentage moves upward. A time horizon longer than five years appears to be associated with stronger vertical mobility in the United States (Addison 1997).

For low-paid workers below 65 percent of median earnings, mobility across the income distribution varies considerably between OECD countries. More than half of them are in a higher earning status after five years in Italy (69.8 percent), Denmark (68.3 percent), the United Kingdom (52.9 percent) and France (50.2 percent) in contrast to Germany (44 percent) and the United States (26.9 percent). In some countries, a large proportion of low-paid workers leave full-time employment (Germany, 40.5 percent; United States 39.2 percent). In general, a low share of low-paid workers in total employment (Italy 10 percent, France 11 percent compared to the United States 27,5 percent) seems to be associated with a high vertical mobility (Table 4 and OECD, 1996a, Table 3.9). However, this finding may be somewhat deceptive, since lower wage dispersion means by definition a smaller proportion of low-paid workers, and so their greater mobility is occurring across a more compressed income distribution.[4]

Taking vertical mobility in the earning dispersion into account an unequal earning distribution in a specific year gives less cause for concern.

II. Income inequality and growth

3. One aspect of income inequality is its relationship with economic growth and development. This relationship has been studied in two different directions. The traditional line of research is how growth and development affect income distribution. At the core of this debate was the Kuznetz hypothesis (1955) that inequality rises in the process of economic development and then falls again (inverted u-curve). The more recent empirical evidence tends to reject for this hypothesis (Bruno et al. 1996). In quite a few countries with spectacular growth

[4] When Shorrocks R is used to analyze the permanent part in labor income inequality or in post-government income inequality, the United States has higher levels of income inequality and a higher permanent share of post-government inequality in the 80s and the 90s than Germany (Burkhauser et al. 1998). According to this analysis, income inequality in Germany is oderately increasing in the nineties, including the permanent component of post-government income inequality.

rates in the last decades (Japan, Newly Industrializing Countries) the income distribution has been quite persistent.

The more recent line of research interest is how inequality affects economic growth or to what extent some amount of equality is a necessary precondition for growth. There are three mechanisms working towards a negative impact of inequality on growth:

i) According to the polit-economic approach (Alesina and Rodrick 1994, Bertola 1993) the median voter prefers a higher level of government expenditure and of taxation, the more the median is below the mean, i.e. the more skewed the income distribution is in disfavor of the lower income groups. A higher level of taxation, however, reduces investment and effort. A more unequal income distribution therefore should be associated with lower growth rates.
ii) Another approach stresses political stability as an intervening variable between income distribution and growth (Alesina and Perotti 1996, Benabou 1996, Benhabib and Rustichini 1996). It is argued that in highly heterogeneous and polarized societies interest groups tend to engage in group specific rent seeking or that under such conditions violence and overthrows of governments are likely. Rent seeking leads to political control of the economy by specific groups, to closed markets, cartelization and a general loss in efficiency. The overthrowing of governments creates political and economic uncertainty including uncertainty on property rights (risk of expropriation and a change of taxation) which is detrimental to investment. Both effects cement the unequal income distribution and a low increase in economic well being (path dependence and hysteresis).
iii) A more unequal income distribution makes it harder for the poorer part of the population to invest in their human capital, and this will weaken growth. Groups of the population may get trapped in their low human capital (hysteresis). Capital markets cannot overcome this trap because information

on future income growth due to human capital formation is not available (*Galor and Zeira 1993; Benabou 1996*).

Against this negative impact of an unequal income distribution on economic growth we have to consider a positive mechanism, i.e. the hypothesis that a more unequal income distribution is instrumental in a Schumpeterian sense to bring about a higher level of entrepreneurial effort, work effort and a higher level of capital accumulation financed by higher savings[5] (on employment see below). Thus taking all arguments together, from a theoretical point of view the sign of the relationship between inequality and growth is not determined.

Nevertheless, it seems that in a *Gedankenexperiment* we can indicate some limits where an increase in inequality will start to have a negative impact on growth. When inequality leads to instability of a society it is hard to conceive that this would be beneficial for growth.

4. Most empirical studies estimating reduced-form equations where income distribution enters a neoclassical growth equation as an additional explanatory variable obtain a positive relationship between equity and growth (e.g. Bourguignon 1996; Perotti 1996; Persson and Tabellini 1994). These results must, however, be taken with a grain of salt because the distribution data used are of questionable quality (Deininger and Squire 1996). Preliminary estimates by Deininger and Squire with the more reliable World Bank data show an insignificant coefficient of the distribution variable when regional dummies are included. More empirical research is needed to achieve firm conclusions about the impact of inequality on growth.

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[5] Compare the Kaldor hypothesis (1957) that the marginal propensity to save of the rich is much higher than that of the poor which implies a positive impact of inequality on aggregate savings.

Structural form estimates discriminating between the different transmission mechanisms from equity to growth are rare. The existing evidence clearly rejects the political economy hypothesis (Perotti 1996) which may be due to the fact that the lobbying of interest groups dominates median voter behavior in determining the level of redistribution. There also seems to be no evidence that income inequality affects aggregate savings across countries (Schmidt-Hebbel and Servén 1996). By contrast, the mechanisms emphasizing human capital formation and political instability receive some empirical support (Perotti 1996; Alesina and Perotti 1996). The main problem in testing the political instability hypothesis is to construct an appropriate index of instability. Alesina and Perotti use an index based on indicators such as the number of coups, political assassinations etc. Their index thus fails to reflect the degree of institutional uncertainty that might prevail in weak albeit constitutional governments. It would be interesting to re-estimate the instability channel with an index which is more closely related to the stability of property rights such as that suggested by Barro (1996).

III. Income inequality, equity orientation and unemployment

5. Another important aspect of income inequality is its relationship with employment and unemployment. Some argue that a higher income dispersion will be associated with more unemployment. Their line of reasoning, of course, is not that a greater earnings dispersion will allow a better matching in the labor market bringing about labor market equilibria on the different steps of the productivity staircase of an economy. And they do not emphasize that in an environment of higher wage differentiation the prospect of reaching a higher wage is a strong incentive for human capital formation for the individual employee, and thus for vertical mobility. Rather, the argument is placed in an insider-outsider model of hysteresis where greater unemployment occurs exogenously (and is considered as not being affected by the extent of wage differentiation). Once people lose their job, those with previously low labor income are exposed

to a higher risk of getting marginalized. As unemployed they will not have a chance to improve their human capital out of their own means, and they will not participate in increases in labor productivity of the economy by training on the job. Moreover, due to their social status and social environment (including housing) they are exposed to a much greater risk of social disintegration including crime. This is especially relevant if unemployment is concentrated on ethnic or other subgroups of society (adverse selection). In addition, these groups will be part of a weaker network that otherwise could be helpful in the search process for new jobs (Stiglitz and Furman 1998).

Marginalization and disintegration is a phenomenon that cannot be denied. But in terms of economic policy, marginalization of subgroups of society is not necessarily an issue of income policy. The first best approach is to attack it by human capital formation, by improving training on the job, by institutional approaches to training on the job such as an apprenticeship system, by introducing a vocational school system, by better schooling in general and by providing the adequate infrastructure and mending housing and (inner) cities. Moreover, it is somewhat misleading not to consider vertical mobility.

6. I would now like to turn the question around and look at the consequences of a *redistributive policy that puts more emphasis on equity*. The *traditional line of reasoning* is that equity considerations will mean relatively high taxation for those who can bring an economy forward thus impairing effort and investment. „The money must be carried from the rich to the poor in a leaky bucket" (Okun 1975: 91). Redistribution will lead to a loss of economic dynamism and consequently to weaker investment, lower growth and less employment. Witness the incapability of the German political system to agree on a tax reform in 1997/1998, mainly for equity reasons. A more blunt reminiscence is off course the erosion of the equity orientated centrally planned economies in Eastern Europe.

7. But my argument is more subtle. I am interested in the relationship of the welfare state and unemployment. Equity considerations enter into the incentive system of an economy in a variety of forms:

i) A more equity oriented society will impose less stringent conditionality conditions on the unemployed. This can be clearly seen in comparing the replacement rates and the duration of unemployment benefits of the United States, the United Kingdom and Germany (Table 5). In Germany unemployment benefits of type I (Arbeitslosengeld) is paid for one year as a rule, it goes up to 32 months for those over 45 years; unemployment benefit of type II (Arbeitslosenhilfe) is indefinite.
ii) Social welfare tends to be more gracious in countries that are equity oriented. In Germany again, social welfare benefits reach 78 percent of the net wage of the lowest wage group of industry for a family (one earner, one child). This ratio has gone up from 65,7 percent (1970) to 83,4 percent (1995) and then declined somewhat. The difference to a market income is not too large and can be easily bridged in the shadow economy.
iii) With unemployment benefits and social welfare benefits, the welfare state defines a lower income floor which has an impact on employment. It specifies a reservation wage, and it thus affects search behavior of the unemployed representing an incentive not to search too intensively. The lower income floor influences the wage bargaining behavior of trade unions and employers' association because the unemployed are taken care of by governmental schemes. And the lower income floor defines the lower corner stone of the wage structure and thus prevents wage differentiation for the lower steps of the productivity staircase.
iv) Even when reforming the old age pension system in the continental countries of Europe, the lower income floor shows up. Pushing back the pay-as-you system in order to make way for a capital funded system finds a limit as soon as the pension level of the pay-as-you go system (which now is at 70 percent of net wage income in Germany) is approaching the level of social

welfare benefits for important groups of society.[6] This not only blocks the introduction of a capital funded system; it is taken by some as an important motive to do away with a contribution financed pension system altogether and switch over to a tax based system (which no longer has the positive incentive effects associated with contributions).[7]

v) Finally, government spending of the welfare state has to be financed by taxes and social security contributions. This increases the excess burden of taxation and reduces efficiency. Social security contributions paid by firms increase the tax wedge and weaken the demand for labor. All in all, the incentive mechanisms of an economy with a strong welfare state as the German one represent a very complex system that severely contributes to unemployment (Figure 2).

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6 Relative to the standard pension in West Germany, social welfare payments reach 62,6 percent (social assistance including housing, see table). This means that for some groups receiving less than the standard pension (because of a lower earning profile or less than 45 years of working life) reducing contribution financed old age pensions (actually at 70 percent of net wage) in order to make room for a capital funded system comes close to the level of social welfare payments.

Table — Standard pension and social assistance for the elderly in West Germany in 1998

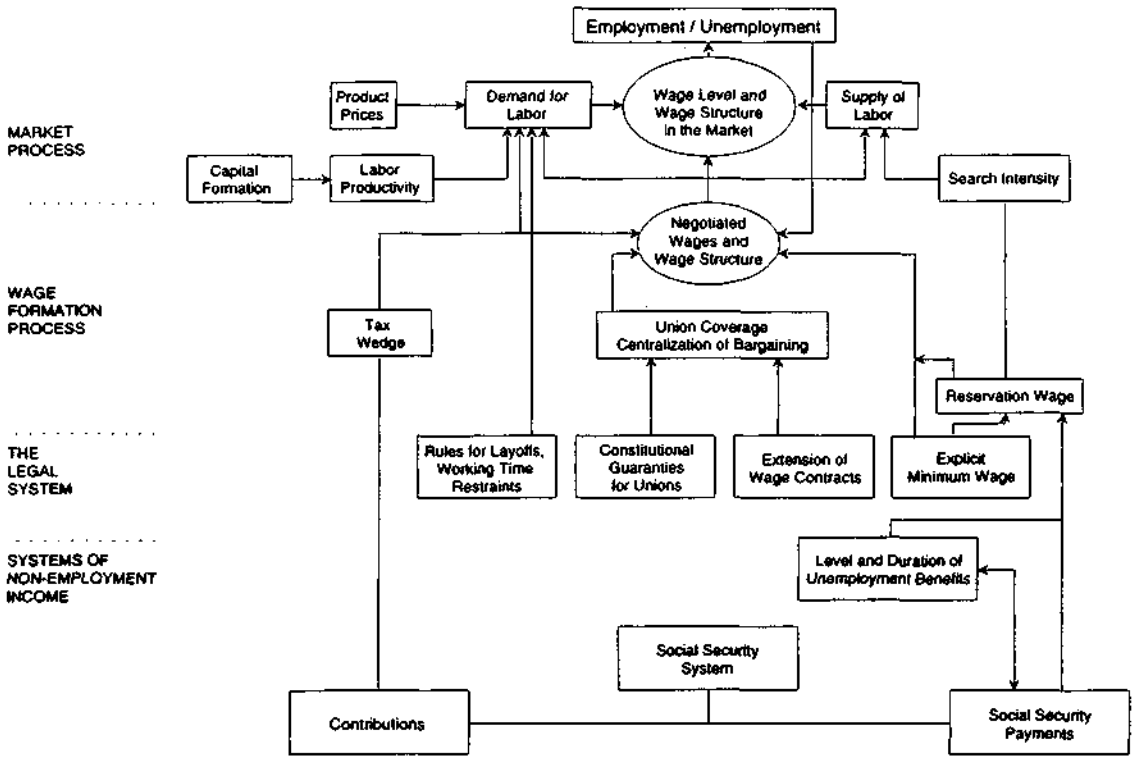
	Single person[a)]	Couple[a),b)]
Standard pension[c)]		
– DM per month	1 977	1 977[d)]
Social assistance[e)] including housing costs		
– DM per month	1 237	2 022
– percent of standard pension	62.6	102.3

a) Aged 65 or more.
b) One income earner.
c) Working career of 45 years, average wage income, net of tax.
d) Potential benefits (e.g. means-tested social asistance) neglected.
e) Including irregular transfers of 81 DM (singles) resp. 145 DM (couple).

Source: Verband Deutscher Rentenversicherungsträger, own calculations.

7 Another example is the need for wage differentiation. Here, it is more acceptable to require a wage subsidy for the lower segments of the labor market.

Figure 2 — The Welfare State and Unemployment



Thus, there are opportunity costs of an equity oriented policy approach in terms of lower employment and higher unemployment.[8] Putting more emphasis on equity brings a country into an institutional trap from which it is extremely hard to escape. This clearly can be observed in the continental countries in Europe.

8. It is difficult to strike a balance between more equity on the one hand and more efficiency, growth and employment on the other hand. There is a range of policy issues when equity and efficiency are in conflict. But there also is a range of problems where equity and efficiency are in harmony. Thus in an evolutionary process, the competitive order is instrumental in contributing to a solution of the social question (Siebert 1992). Moreover, equity considerations should not ignore the long-run impact of a policy approach. A snapshot equity would severely limit an improvement in the long-run.[9] It is quite understandable that people in the United States are concerned with more equity. But before starting to change the US institutions a very close look should be taken at some of the experience from the other side of the Atlantic divide, especially from the continental countries in Europe which have given strong weight to equity considerations in the past.

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[8] An empirical analysis on the impact of the welfare state on employment is extremely difficult. An index of the welfare state would have to be confronted with unemployment rates. Such an index would have to comprise the set of potential causes of unemployment. Determining the weights of the components of such an index (lacking wage differentiation, duration of benefits, replacement ratios, level of welfare payments, lay-off restraints etc.) would presuppose knowing the relevance of different determinants of unemployment. Besides, international comparisons are difficult. Thus, one has to rely on tracing the institutional changes of individual countries over time and looking at their impact (Siebert 1997). There is new evidence, however, that for the OECD countries there is a negative relation between the level of government expenditure (in percent of GDP) and the creation of jobs (Heitger 1998). The higher the level of expenditure, the lower the rate of increase of jobs. This especially holds for consumptive government expenditures; investive governmental expenditures have a positive effect on employment.

[9] Ethical norms should be judged in a general equilibrium including all ramifications in the economy.

Appendix

Table 1 — Change in Market Income Inequality 1960s–1990s (Decadal Averages of Gini-Coefficients)

Country	Observations	1960s	1970s	1980s	1990	Trend in Gini-Coefficients[a]
US	45	34.6	34.5	36.9	37.9	+
United Kingdom	31	25.0	24.3	27.3	32.4	+
New Zealand	11	/	31.4	34.1	/	+
Australia	10	32.0	36.7	36.2	32.5	0
Canada	23	31.6	31.6	31.5	27.5	0
Germany (West)	6	/	36.0	35.8	/	0
Netherlands	9	/	28.1	28.6	/	0
Belgium	8	36.4	42.0	29.6	35.8	0
France	7	48.0	41.6	37.8	/	—
Italy	15	/	37.4	33.4	32.2	—
Norway	7	36.8	35.3	31.0	/	—
Sweden	14	/	33.1	33.7	32.3	0
Finland	6	/	30.7	31.0	/	0
Japan	22	35.6	34.1	34.4	35.0	0
Taiwan	26	31.2	29.3	29.0	30.5	0
Singapore	6	/	39.0	40.7	/	0
Hongkong	10	47.5	41.9	41.4	45.0	0
Korea	10	31.5	36.1	35.6	/	0

[a]'0' indicates no significant trend.

Source: K. Deininger and L. Squire (1996).

Table 2 — Change in Disposable Income Inequality

Country	Time Interval	Change of Gini-Coefficients[a]
USA	1979–1993	+++
United Kingdom	1979–1995	++++
New Zealand	1981–1989	+
Australia	1981–1989	+
Canada	1979–1994	0
Germany (West)	1979–1990	0
Netherlands	1979–1994	+++
Belgium	1985–1992	+
France	1979–1989	0
Italia	1979–1991	—
Denmark	1981–1990	++
Norway	1979–1992	0
Sweden	1979–1994	+++
Finland	1979–1994	0
Spain	1980–1990	0
Portugal	1980–1990	0
Ireland	1980–1987	0
Japan	1979–1993	++
Israel	1979–1992	0

[a]The symbols have to be interpreted as follows:
++++ very large increase (> 30%)
+++ large increase (16 to 29%)
++ moderate increase (10 to 15%)
+ low increase (5 to 10%)
0 zero (–4 to +4%)
— decline (> -5%)

Source: P. Gottschalk and T.M. Smeeding (1997a, 1997b).

Table 3 — Five-Year Earnings Mobility,[a] 1986–1991

	Pearson correlation coefficient	Stayed in the same quintile	Moved one quintile	Moved 2 or more quintiles
	%	%	%	%
France	0.760	56.8	32.0	11.2
Germany	0.793	53.0	35.7	11.2
United Kingdom	0.705	48.1	36.8	15.1
United States	0.680	48.8	35.5	15.7

[a]Full-time wage and salary workers.

Source: OECD (1996) Table 3.6

Table 4 — Five-Year Earnings Mobility[a] of Low-Paid Workers[b], 1986–1991

	Share of low-paid workers in 1986	No longer employed full-time	Still below 0,65 median	0.65 to 0.95 median	Above 0.95 median
France	11.0	26.2	23.2	35.4	14.8
Germany	18.7	40.5	15.5	29.7	14.3
United Kingdom	17.7	13.3	33.8	34.6	18.3
United States	27.5	39.2	33.9	17.2	9.7

[a]1991 earnings status of 1986 low-paid workers. — [b]Defined as below 0.65 median earnings.

Source: OECD (1996) Table 3.9.

Table 5 — Replacement ratios and duration of benefits in selected countries

	US	UK	Germany	France
Replacement ratio in percent of previous net wage income	50–70[a]	[b]	67[c], 57[d]	43[e]
OECD average measure for the replacement ratio	14	23	43	48
Duration of benefits[f]	6	6	[c]12 months, up to 32 months for unemployed people above age 57 [d]Indefinite	up to 60 months
Level[g] of social welfare[h]				
– Single person	15[i]	23	23	30
– Couple with two children	44[i]	60	63	56

[a] Differences between the states.

[b] Independent of previous net wage; 60 percent of net wages in the economy for a married couple with two children (aged under 5 resp. 5–10).

[c] Unemployment benefit I (Arbeitslosengeld) for unemployed persons with children (60 percent otherwise).

[d] Unemployment benefit II (Arbeitslosenhilfe), means-tested, for unemployed persons with children (53 percent otherwise).

[e] Reduction according to the length of the period of unemployment (down to an absolute minimum of about DM 26 per day).

[f] Months of unemployment.

[g] Social assistance as percentage of net disposable income at average earnings (after reduction of housing costs from benefits and net wages). When housing is included the number is higher (Siebert 1998).

[h] General assistance (United States: Food stamps, general assistance (by the states); United Kingdom: Income support; Germany: Subsistence aid (Sozialhilfe); France: Revenu Minimum d'Insertion); OECD definition.

[i] Pennsylvania (Texas: 10 resp. 30 percent).

Source: OECD (1994, 1996b); Sachverständigenrat (1997).

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